

This suggestion is not compatible with either the operating characteristics of small and mid-size ECs or the Commission's own policy statements. Telephone companies require a continuum of regulatory plans that have built into them a tradeoff between risk and return. The Commission has stated that incentive plans are optional, except for the largest of companies, and were not intended to be mandatory for small companies.<sup>52</sup> NTCA and OPASTCO advise that the elements of incentive options may not be compatible with the operations of some small and rural ECs.<sup>53</sup> According to NTCA, high costs, low or unpredictable traffic volumes, and sparsely-populated service areas could result in variations in operations which make the commitment to rigid per-unit settlements too risky for some ECs.<sup>54</sup> For example, the loss of one large customer could impair the viability of a small EC. Both NTCA and OPASTCO agree that NECA's incentive settlement plans should be adopted as options thereby affording pooling companies the opportunity to continue to choose cost or average schedules settlements.<sup>55</sup> Therefore, as requested in NECA's Petition for Rulemaking, the proposed incentive plans should be optional.

D. NECA's Proposed Settlement Rate Calculations are Reasonable

In this section, NECA demonstrates that MCI, GCI and AT&T draw incorrect conclusions with regard to the mechanics of NECA's optional incentive plans and that their suggestions for more specificity are unfounded and without merit.

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<sup>52</sup> See Second Price Cap Order, 5 FCC Rcd at 6787 and 6818-1819; and n. 35 supra.

<sup>53</sup> NTCA at 2; OPASTCO at 5; and n. 21 supra.

<sup>54</sup> NTCA at 2.

<sup>55</sup> NTCA at 2; OPASTCO at 5.

NECA's fixed settlement rate for its Customer Option Dividend for the first two-year period is calculated at the authorized rate of return, using the ECs' prior calendar year historical cost and demand.<sup>56</sup> Both MCI and GCI assert that these carriers' costs over the last 12 months may not be representative of typical costs and should not be used in determining the initial settlement rates.<sup>57</sup> NECA has simply followed the Commission's practice of using prior calendar year data to set initial rates for incentive companies. In both its AT&T and EC Price Cap Orders, the Commission similarly used the then effective rates as the starting point for initial incentive rates.<sup>58</sup> Prior year historical cost and demand are also used to establish incentive rates under section 61.39 and 61.50 of the Commission's rules, 47 C.F.R. §§ 61.39 and 61.50

AT&T, MCI and GCI state that NECA has not justified its customer dividend and its productivity estimates.<sup>59</sup> AT&T asserts that NECA has not substantiated its 0.65% factor nor shown how this customer dividend factor will lead to greater efficiencies.<sup>60</sup> MCI and GCI state that taking half the difference between the highest and lowest productivity factors, which the Commission has established for Tier 1 price cap carriers, is an arbitrary measure and is not tied to the actual productivity performance of NECA member companies.<sup>61</sup> MCI and GCI assert that an analysis of

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<sup>56</sup> See Supplemental Comments at 11 and Attachment 3.

<sup>57</sup> GCI at 2; MCI at 2.

<sup>58</sup> See AT&T Price Cap Order, 4 FCC Rcd at 3084-3085 and Second Price Cap Order, 5 FCC Rcd at 6814.

<sup>59</sup> AT&T at 5; MCI at 2-4; GCI at 1-3.

<sup>60</sup> AT&T at 5.

<sup>61</sup> MCI at 3; GCI at 1-2.

the carriers' historical productivity performance must be made.<sup>62</sup> Without this calculation, MCI believes that the productivity offset may be understated.<sup>63</sup>

NECA gave careful consideration to the difficulty and results demonstrated in the Commission's 1990 productivity studies for large ECs.<sup>64</sup> The Commission itself decided to conduct these productivity studies for EC price caps after it had rejected separate productivity studies submitted by ECs.<sup>65</sup> At that time, the Commission cited the difficulty in judging the diversity of approaches used to measure productivity.<sup>66</sup> The Commission's study required a significant industry effort to net out the effects of regulatory changes from historical data.<sup>67</sup> Reinterpretation of the study by the Commission, as discussed in the Price Cap Review Order, shows that these types of studies result in continuing controversy and are subject to many varying interpretations.<sup>68</sup>

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<sup>62</sup> MCI at 3-4; GCI at 1-2.

<sup>63</sup> MCI at 3.

<sup>64</sup> See Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Supplemental Notice of Proposed Rulemaking, 5 FCC Rcd 2176, 2222-2225 (1990) (Supplemental NPRM) and Appendix C, A Study of Local Exchange Carrier Post-Divestiture Switched Access Productivity (Frentup-Uretsky study) and Appendix D, Total Telephone Productivity in the Pre- and Post-Divestiture Periods (Spavins-Lande Study). After examining suggestions and criticisms in the comments filed, as well as data submitted by AT&T and USTA, the Commission revised these two staff studies. See also Second Price Cap Order, 5 FCC Rcd at 6796-98 and Appendix C (Revised Frentup-Uretsky Study) and Appendix D (Revised Spavins-Lande Study).

<sup>65</sup> See Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-213, Further Notice of Proposed Rulemaking, 3 FCC Rcd 3195, 3401-3408 (1988) (1988 FNPRM Notice). See also AT&T Price Cap Order, 4 FCC Rcd at 2975-2997; and Supplemental NPRM, 5 FCC Rcd at 2212-2222.

<sup>66</sup> See Supplemental NPRM, 5 FCC Rcd at 2227 and Second Price Cap Order, 5 FCC Rcd at 6796.

<sup>67</sup> See Second Price Cap Order, 5 FCC Rcd at 6798-99.

<sup>68</sup> See Price Cap Review Order at ¶¶ 144-145

In light of the difficulties encountered by the Commission regarding these productivity studies, rather than doing another productivity study, NECA examined the section 61.39 plan (which involves freezing rates) and the Optional Incentive Regulation (OIR) plan in section 61.50 (which involves freezing rates and profit sharing). NECA patterned its plan after the 61.39 and 61.50 plans, but eliminated profit sharing in response to the recent Price Cap Review Order.

Both of these plans freeze rates for two-year periods. By freezing rates, these Commission options have implicitly established for smaller companies a productivity rate equal to the rate of inflation. For larger NECA ECs that elect the Customer Dividend Option, NECA added a customer dividend of 0.65%, and assuming that inflation continues to equal 3.0%, the overall productivity factor would be 3.65%.<sup>69</sup> Freezing rates as NECA does in its Small Company Option, or lowering rates an additional 0.65% each year of the two-year settlement period in the Customer Dividend Option, are challenging productivity hurdles.

MCI questioned whether the implicit small company productivity measure, equal to the rate of inflation, will remain at 3.0%, “especially in an industry with declining costs.”<sup>70</sup> The theory behind requiring productivity improvements equal to the inflation rate is not dependent on the level of inflation. Historical cost and demand commitments mean that an EC will have to improve operations more than whatever the inflation rate turns out to be if the EC is to benefit.

NECA derived the additional 0.65% customer dividend for larger companies by taking half of the 1.3% difference between the 4.0% productivity factor for the basic EC price cap offering with

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<sup>69</sup> Supplement Comments at 8.

<sup>70</sup> MCI at 4.

profit sharing and the 5.3% productivity factor for the option without profit sharing.<sup>71</sup> The dividend chosen is purposefully lower than the 1.3% dividend required by the Commission of price cap companies for the option without profit sharing.<sup>72</sup> By selecting a midpoint, NECA recognized that the smaller companies in the NECA pool have fewer opportunities than the larger price cap companies to reduce costs through scale economies or by offering complementary services.<sup>73</sup> NECA believes that its customer dividend factor is within a reasonable range.

NECA also recognized the need for a careful balance in determining the productivity factor for each option. If the productivity factor is set too high, there will be no participants. Setting it too low, on the other hand, could result in higher profits than are needed. OPASTCO states that the selected productivity factor, combined with the greater volatility of cost and demand changes associated with small study areas, produces a proper balance between risk and reward for NECA pool ECs.<sup>74</sup>

MCI also urges the Commission to require a sharing mechanism to compensate for the complexity of calculating accurate settlement rates and productivity.<sup>75</sup> This again raises the issue of the proper tradeoff between risk and return for an incentive plan. MCI suggests that a sharing

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<sup>71</sup> Supplemental Comments at 7.

<sup>72</sup> Price Cap Review Order at ¶ 199-200.

<sup>73</sup> See Supplemental Comments at 7. See also Second Price Cap Order, 5 FCC Rcd at 6799. Regarding productivity factors for small to mid-size ECs, the Commission stated that “. . . and the diverse characteristics of smaller LECs, lead us to conclude that it is best premature to mandate either overall or individual productivity factors for them.” Id.

<sup>74</sup> OPASTCO at 5

<sup>75</sup> MCI at 4.

mechanism similar to one imposed on price cap companies electing lower productivity levels would protect the interests of ratepayers.<sup>76</sup> MCI's proposal, however, is contrary to current Commission policy. The Commission has stated it favors the elimination of profit sharing from its permanent price cap plan for ECs.<sup>77</sup> In light of the Commission's position, a sharing mechanism is not necessary.

Furthermore, ratepayers are protected by the backstop feature of NECA's plan that requires resetting incentive settlement rate levels to the authorized rate of return every two years.<sup>78</sup> The Commission adopted this same mechanism for its Section 61.39 and Section 61.50 plans.<sup>79</sup> As with the other alternative regulation plans, this automatic settlement rate adjustment recognizes the inherent risk of incentive regulation for small and mid-size companies, and protects both companies and ratepayers from the unanticipated impacts of imprecise initial targets.

Finally, AT&T is concerned that the earnings of non-incentive pool members could diminish any productivity benefits by incentive pool members. It asserts that nonparticipating pool companies would have no incentive to achieve greater efficiencies and productivity levels.<sup>80</sup> The notion that non-incentive pool members could dilute the productivity gains of incentive members is incorrect.

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<sup>76</sup> Id. at 4.

<sup>77</sup> Price Cap Review Order at ¶ 184 and n. 11 supra.

<sup>78</sup> Another factor in arguing that profit sharing is not warranted may be found in the OIR experience. A possible explanation for why only one EC chose the OIR option is that profit sharing lowers potential rewards to the point they no longer compensate for the risks associated with freezing rates for two years.

<sup>79</sup> These plans and NECA's proposed incentive options include a self-correcting true-up mechanism at two-year intervals which is not found in price cap regulations. See Section 61.41 et seq. of the Commission's rules, 47 C.F.R. § 61.41 et seq.

<sup>80</sup> AT&T at 4.

An EC under incentive regulation in the pool has its settlement rates per unit of traffic preset to the authorized rate of return based on its study area-specific historical cost and demand data. The EC must lower its study area cost per unit of traffic below this settlement rate if it is to increase its earnings above the authorized level. Similarly, if its cost per unit of traffic rises above the settlement rate, its earnings will fall. The efficiency levels of other companies in the pool do not alter these conditions which are based on an EC's study area-specific unit costs.<sup>81</sup>

### **III. CONCLUSION**

NECA's proposed plans advance Commission incentive policy statements and are consistent with other optional plans adopted by the Commission that are currently in place. As discussed above, NECA has demonstrated that optional incentive regulation lowers access rates and benefits ratepayers. In addition, NECA has demonstrated that its productivity factors and settlement rates are reasonable. NECA's plans allow access customers, the Commission and exchange carriers to benefit from incentive regulation while retaining the administrative efficiencies of pooling.

In conclusion, NECA requests that the Commission initiate a rulemaking proceeding to propose the Customer Dividend Option and its Small Company Incentive Option. Pricing flexibility,

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<sup>81</sup> NECA will continue to adjust the earnings of all pool members (cost companies, average schedules and, if approved, incentive companies) to reflect actual pool earnings. All companies expect to share in the risks and rewards of pool rate setting. NECA access rates would add projected incentive company and average schedule settlements to forecasted cost company revenue requirements to determine the pool revenue requirement. This total revenue requirement would then be divided by total forecasted demand. To the extent that these tariff forecasts are wrong, all pool members share in the resulting variance. Both incentive company and average schedule settlements will be adjusted upward or downward as overall pool performance changes. See Supplemental Comments, Attachment 3. The earnings adjustments, however, would have no effect on study area-specific efficiency incentives nor would they alter the settlement mechanism for other pooling companies.

streamlined filing procedures, and pro forma rule changes which NECA proposed in its 1993 Petition for Rulemaking should also be advanced. Adoption of these incentive options will allow NECA's pool members and their customers to receive benefits of incentive regulation that the Commission has adopted for companies that are no longer NECA pool members.

Respectfully submitted,

NATIONAL EXCHANGE CARRIER  
ASSOCIATION, INC.

Donna A. DiMartino  
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Its Attorney

July 5, 1995

# TS RATES FOR NON - POOLING ECs

## FCC SECTION 61.39

		12/1993 USF LOOPS	SETT TYPE	SAC	Composite CUR Rate	Composite PRO Rate	Percent Changes
1	Bay Springs Tel Co	10099	C	280446	0.072920	0.047521	-34.8%
2	Beehive Tel Co - NV	70	C	552284	0.337100	0.095180	-71.8%
3	Beehive Tel Co - UT	489	C	552284	0.337100	0.095180	-71.8%
4	Chickamauga tel Corp	5177	A	220354	0.060920	0.059166	-2.9%
5	City of Brooking	12514	C	391650	0.040101	0.038318	-4.4%
6	Elkhart Tel Co	1464	C	411764	0.192600	0.187200	-2.8%
7	Fidelity Tel Co	11001	C	421882	0.048511	0.055028	13.4%
8	Bourbeuse Tel Co	1825	C	421859	0.050408	0.063400	25.8%
9	Great Plains Comm Inc	25481	C	371577	0.041700	0.055700	33.6%
10	Alhambra-Grantfork Tel Co	1025	C	340978	0.105268	0.089391	-15.1%
11	Ayrshire Farmer Mutual Tel Co	405	C	351105	0.262011	0.259140	-1.1%
12	C-R Tel Co	908	C	341009	0.070100	0.086159	22.9%
13	Cass County Tel Co	2763	C	340984	0.079193	0.071120	-10.2%
14	Citizens Tel Co Missouri	3785	C	421865	0.101842	0.090728	-10.9%
15	East Ascension Tel Co	26659	C	270429	0.046210	0.026480	-42.7%
16	Egyptian Tel Coop	2709	C	341003	0.113776	0.113776	0.0%
17	El Paso Tel Co	1726	C	341004	0.071747	0.065857	-8.2%
18	Grafton	668	C	341020	0.097735	0.084244	-13.8%
19	GridLy Tel Co	1234	C	341023	0.096077	0.128168	33.4%
20	Kerman Tel Co	5059	C	542324	0.036421	0.027597	-24.2%
21	La Harp Tel Co	1056	C	341043	0.124649	0.137201	10.1%
22	Leaf River Tel Co	582	C	341045	0.240828	0.206229	-14.4%
23	Madison Tel Co	1392	C	341049	0.129472	0.150195	16.0%
24	Oneida Tel Co	503	C	341066	0.134753	0.134753	0.0%
25	Moultrie Independent tel Co	669	C	341060	0.376584	0.371814	-1.3%
26	Roosevelt County Rural Tel Coop	1638	C	492272	0.104303	0.093293	-10.6%
27	Sierra Tel Co	15024	C	542338	0.067682	0.062798	-7.2%
28	Webb-Dickens Tel Corp	411	C	351327	0.158799	0.152624	-3.9%
29	West River Telcom Corp	9197	C	381637	0.049712	0.059212	19.1%
30	Woodhull Community Tel Co	649	C	341091	0.138526	0.137580	-0.7%
31	Flat Rock Tel Co	479	C	341012	0.068422	0.107586	57.2%
32	Shawnee Tel Co	3894	C	341025	0.103801	0.102581	-1.2%
33	Wabash Tel Co	4564	C	341088	0.084681	0.084681	0.0%

Note 1: Composite Rate = ( LS2 + Info Surcharge + RIC + 2 X Tandem Switched Termination + 10 X TSF + Tandem Switching Charge). If the EC uses a different rate structure, then the equivalent of these charges are used.

Note 2: For "Sett Type", "C" = Cost Company & "A" = Average Schedule

Note 3: "SAC" = Study Area Code

Note 4: ECs #16, 24, & 43 are excluded from analysis since they were not required to file new rate for 7/1/95

# TS RATE FOR NON - POOLING ECs

## FCC SECTION 61.39

		1994 USF LOOPS TYPE	SAC	Composite CUR Rate	Composite PRO Rate	Percent Changes
34	Bloomingsdale Home Tel Co	577 A	320742	0.111580	0.101470	-9.1%
35	Buffalo Valley Tel Co	17116 C	170151	NECA	0.059772	N/A
36	Denver & Ephrata Tel & Telegraph	45586 A	170165	0.045465	0.043602	-4.1%
37	Lexington Tel Co	26588 A	230483	0.048212	0.047428	-1.6%
38	Mankato CitizensTel Co	31131 A	361427	0.051103	0.050095	-2.0%
39	Merchants & Farmers Tel Co	554 C	320788	0.105027	0.096236	-8.4%
40	Mid- Comm Inc	7870 A	361375	0.094369	0.083227	-11.8%
41	Wilton Tel Co	2513 C	120050	NECA	0.051636	N/A
42	Atlantic Tel Membership Corp	25318 C	230468	0.033058	0.022372	-32.3%
43	Coastal Utilities Inc.	26549 C	220356	0.037010	0.033565	-9.3%
44	Farmers Tel Coop	43315 C	240520	0.028910	0.026307	-9.0%
45	Hargray Tel Co	37960 C	240523	0.047306	0.052141	10.2%
46	Millington Tel Co	22268 C	290571	0.033677	0.021146	-37.2%
47	Mt. Horeb Tel Co	3503 C	290571	0.070011	0.061203	-12.6%
48	Pineland Tel Co	10306 C	220377	0.040314	0.029104	-27.8%
49	Bixby Tel Co	6442 C	431969	NECA	0.030982	N/A
50	Clifton Forge Waynesboro Tel Co	30990 A	190226	NECA	0.050485	N/A
51	Electra Tel	1700 C	442069	NECA	0.083188	N/A
52	Floral Tel Co	3841 C	210291	NECA	0.040825	N/A
53	Gulf Tel Co	8047 C	210329	NECA	0.023974	N/A
54	Haxton Tel Co	1481 C	462190	NECA	0.083188	N/A
55	Lafourche Tel Co	12559 C	270433	0.049678	0.076919	54.8%
56	Magazine Tel Co	843 A	401710	0.066020	0.101685	54.0%
57	MCTA Inc	9830 C	123321	NECA	0.058019	N/A
58	Merrimack County Tel Co	5794 C	120047	0.068364	0.054655	-20.1%
59	Mokan Dial Inc .KS	2699 C	411807	NECA	0.083188	N/A
60	Mokan Dial Inc MO	650 C	421807	NECA	0.083188	N/A
61	Pioneer Tel Assn	13348 C	411817	NECA	0.096406	N/A
62	Southern Kansas Tel Co	4013 C	411833	0.127724	0.134192	5.1%
63	ST.Joseph Tel & Tel Co	24971 C	210339	NECA	0.027279	N/A
64	Taconic Tel Co	22109 C	150084	0.046529	0.046253	-0.6%
65	Union Tel Co	3262 A	512297	0.116582	0.156204	34.0%
66	Tatum tel Co	784 C	442150	NECA	0.083188	N/A
67	Vista - United	10242 C	210330	0.033180	0.028743	-13.4%

### 61.39 TOTALS

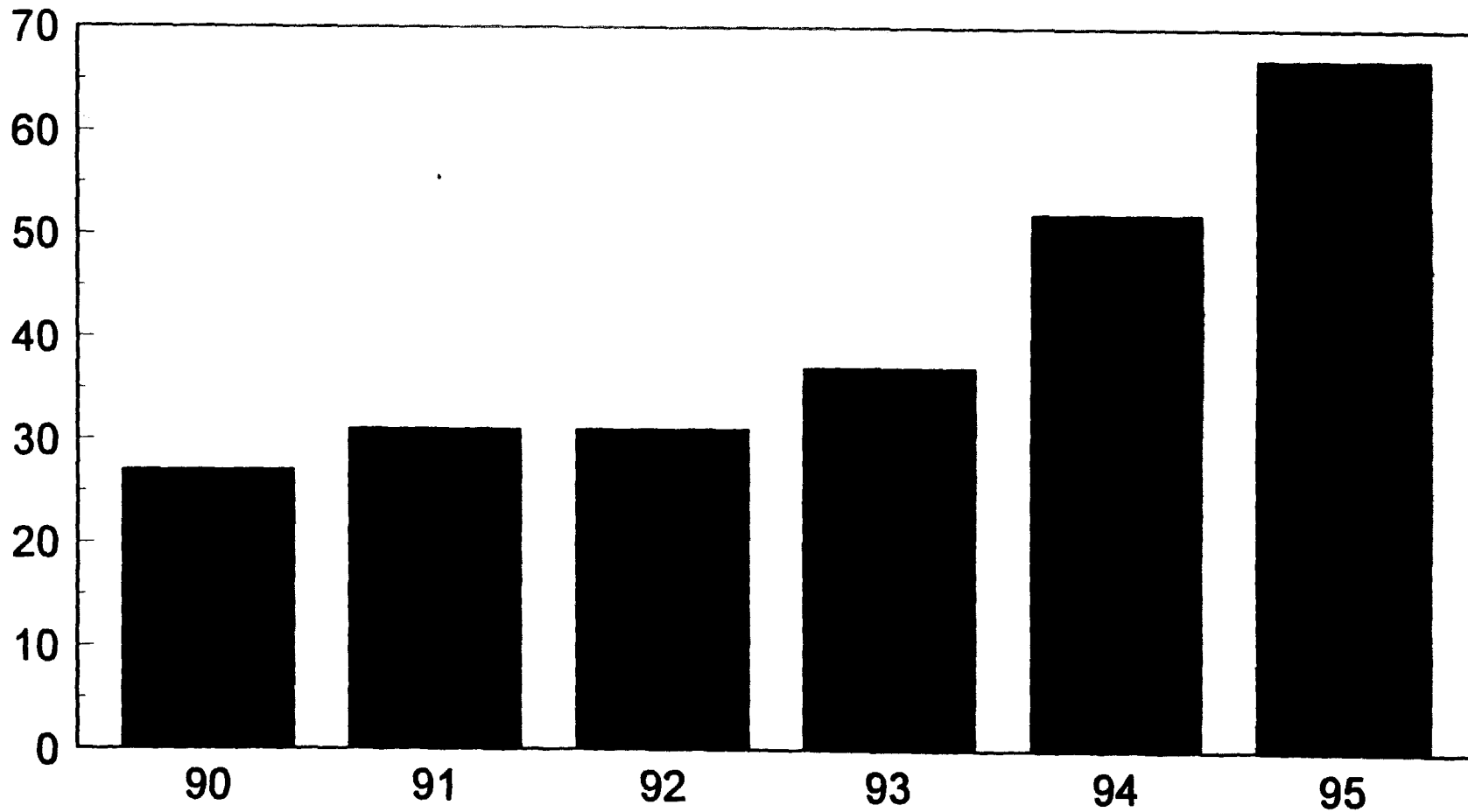
0.050616 0.0489653

### 61.39 TOTALS FOR ECs WITH CURRENT & PROPOSED RATES

0.050616 0.048306 -4.6%

Note: Current and Proposed rates are weighted by the number of USF Loops

# COMPANIES ELECTING 61.39 STATUS (CUMULATIVE BY YEAR)



Data Taken as of July 1 of each year shown

## CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing Reply Comments were served this 5th day of July 1995, by mailing copies thereof by United States Mail, first class postage paid, or by hand delivery, to the persons listed below.

By: /s/ Donna A. DiMartino

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